Enhancing trust and internal controls to reduce risk amid rising material weaknesses

Enterprise Control

A PwC Product

As organizations face resource constraints and struggle to maintain precision and frequency in operating and testing controls, leveraging technology is crucial. Technology can help you automate control operations and testing—increasing precision and early detection of weaknesses—and ultimately reducing the risk of material weaknesses in your environment.

What we're seeing in the market: a "perfect storm"

In October 2021, PwC released a report on material weakness disclosures in IPOs. At that time, an average of 43% of companies had disclosed at least one material weakness (MW) between 2016 and 2021; 50% had disclosed an MW in the first half of 2021 alone.

Fast forward to 2022 and a resurgence of the material weakness.

As compared to 2021, there had been a sharp increase (73%) in the prevalence of MWs disclosed in public companies' annual SEC Form 10-K submissions. Many of these MWs (62%) were also being reported in smaller organizations' 10-Ks. And this trend appears to have continued into at least the first quarter of 2023 (25% | Q1 2022 – Q1 2023).

By all indications, the volume, complexity and extent of compliance activities has increased—and continues to do so. To pinpoint the root cause—and the effects—of what we're seeing overall, we should look at some of the challenges organizations have faced in recent years.

PwC's bi-annual Global Crisis and Resilience Survey released in April 2023 revealed that 9 in 10 organizations (96%) reported that they had experienced multiple major disruptions in the past two years. Of the 1,812 business leaders who shared company data and insights on the impact of the crisis, 76% said their most serious disruptions had a medium-to-high impact on operations.

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↑25% Q1-Q2 2023

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However, it’s evident that some common categories are helping to create a “perfect storm” that’s resulting in a spike in MWs, in particular:

- Personnel shortages
- Segregation of duties (SOD) conflicts
- The financial close process
- IT general controls
- Management review controls
- M&A and integrations

We can see what’s contributing to this “perfect storm.” From there, we can distill this to three core issues:

1. System changes
2. Resource constraints
3. Complacency

Let’s take a closer look at each of these issues and what we can do to mitigate their impact.

1. System changes | Turn a potential risk into an opportunity

- ERP transformations and SaaS/Cloud migrations
- Complex data integrations, process and change management

System change activity is taking center stage—and has been for a while. Many organizations are choosing to go with SaaS products for their enterprise resource planning (ERP), human capital management (HCM) or supply chain management (SCM). With these transformations, business processes are changing. Controls and security need to change as well.

The upsurge in ERP systems implementation—and SaaS/cloud migrations specifically—can be major contributors to MWs. ERP transformations generally involve the integration of various functions, data sources and processes. If you don't plan these transitions carefully, you risk creating challenges in establishing effective internal controls—and this can lead to MWs. However, when managed effectively, we've seen many larger clients make significant improvements to their control environment. They've accomplished this by simply leveraging the ERP change event as a catalyst to revitalize controls that may have been untouched for decades.

2. Resource constraints | Fewer people, but more controls

- Economic volatility and budget limitations
- Fewer people to operate and test controls, with diluting skillsets

Regulatory guidelines and compliance requirements have continued to increase along with the need for resources to address this additional work. Organizations are operating leaner, but they're still asking their people to do the same amount of work—or more. However, many organizations are still recovering from the resource constraints, repercussions and economic volatility resulting from the pandemic. And compliance organizations haven't been immune to any of this.

With budget limitations and a shortage of skilled personnel to establish and maintain robust internal controls, these organizations risk becoming more susceptible to MW. Put simply: the volume, complexity and extent of regulatory guidelines and compliance-related requirements and responsibilities haven't decreased. Having fewer people available—or with the necessary skills—to operate and test internal controls can trigger control breakdowns and broader MW. When we see significant change happening, we should ask whether we're still focusing enough on the right concerns and simplify as much as possible.

3. Complacency | Less vigilance can lead to increased risk

- Many years of Sarbanes-Oxley Act (SOX) and more regulation, but less vigilance maintaining controls
- A belief that controls are sufficient—or still required—resulting in less monitoring or evaluation of their effectiveness

We've seen an element of complacency and drift occurring in the market, and this seems to be a contributing factor to the rise of MWs. Since the initial implementation of SOX regulations in 2002, some organizations appear to have become less vigilant in maintaining strong internal controls.

Despite two decades of technological advances, most businesses today continue to navigate compliance with a distinctly pre-digital mindset. Many controls and processes, for example, still entail manual effort. On average, only 15% of a company's SOX controls are automated, according to PwC research. PwC's 2022 Global Risk Survey found that keeping pace with digital transformation and compliance pressures are among today's top overall business concerns. Almost three-quarters (74%) of respondents told us external compliance requirements are consuming the resources and time of the risk-management function. When we reevaluate the status quo and consider what's truly needed to address risk—and use technology to reduce it—that's where we see the most impact.

Technology has changed the game. It's time your approach to risk management evolved as well.

The rise of MWs in financial reporting can pose significant risks to organizations and undermine the trust of investors and stakeholders. Understanding the causes of MWs can be crucial for developing effective mitigation strategies. Together, these three core themes of system change, resource constraints and complacency can act like an undercurrent of disruption. And many organizations have struggled since the COVID-19 pandemic with remote staff operating and testing increasingly complex controls. Trends like this alone may justify taking a closer look at your current investment around the tech that's enabling the operation and testing of controls — and the people you count on to perform this work.

- Start by understanding the controls you operate today. Increased maturity can help amplify the impact of technology by enabling more intelligent controls to help reduce manual monitoring controls.

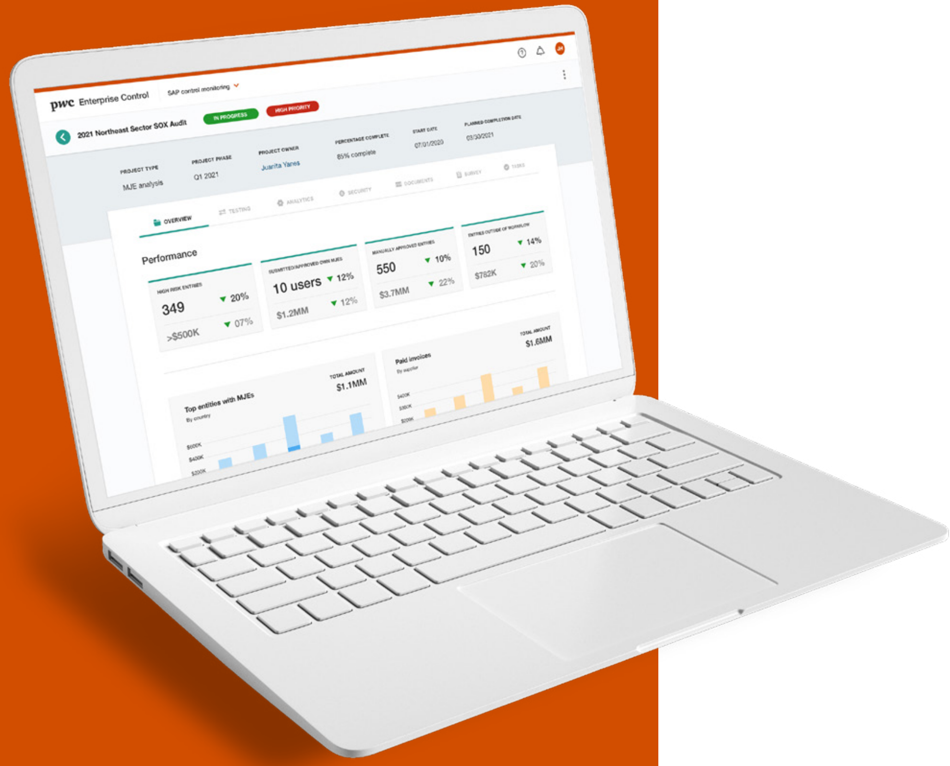
- Consider automating the operation and testing of your controls. With controls automation, you can integrate your three lines of defense: management, risk management and compliance, and internal audit. This can help your organization make the most of your data, predict outcomes and identify issues without needing a scheduled audit.

- View ERP transformations as an opportunity to help modernize your controls environment and shift the ratio of manual to automated controls in the right direction.

Get ahead of the MW resurgence

Enterprise Control is a technology platform infused with trusted PwC knowledge to help you automate controls operation and testing. It can monitor systemic risks proactively with easy-to-use dashboards and can automate control testing in an end-to-end risk and control solution.

With Enterprise Control, you can lower the cost of compliance with automation, exert control over unexpected risks, and designate accountability to drive quicker response and results. Infused with PwC's knowledge of enterprise applications and internal controls, Enterprise Control can automate the creation of test workpapers. This can help reduce the need for manual execution and testing time without sacrificing the quality and accessibility of information needed to produce results.



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As technology advances and your workforce strategy changes, your business' automation should scale accordingly.

Enterprise Control allows you to work smarter, better leverage your current resources and drive your compliance program more efficiently. With PwC-powered technology and knowledge, Enterprise Control can help you manage risk and compliance costs. And digitally upskilling your people can help lead to citizen-led innovation for human-led/technology-powered transformation.

Connect with our team to learn more.

Contact us